

**The Financial Products Specialist Program
Controls Could Be Improved to Ensure More
Timely and Accurate Examinations of Large
Corporations**

September 2002

Reference Number: 2002-30-147

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 12, 2002

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS
DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Acting Inspector General

SUBJECT: Final Audit Report - The Financial Products Specialist Program
Controls Could Be Improved to Ensure More Timely and
Accurate Examinations of Large Corporations
(Audit # 200230006)

This report presents the results of our review to assess how timely the expertise of Financial Products Specialists is requested by and delivered to Large and Mid-Size Business (LMSB) Division examiners. The LMSB Division's return on investment for the financial products specialist program is high. However, their services are not always timely requested by and delivered to LMSB Division examiners. In addition, examiners conducting Industry Case (IC) corporate examinations do not consistently request the assistance of a Financial Products Specialist when examination procedures require such involvement. As a result, significant financial products tax issues have been overlooked.

In summary, we found that while the time span of the examinations is not always under the direct control of examiners and their managers, steps can nevertheless be taken to better focus attention on improving the timeliness of examinations. Specifically, management's information system needs enhancing because it does not capture information on when an examination is started or why delays are occurring. In addition, key milestones such as planned start and completion dates are missing. Consequently, the LMSB Division is inhibited in its ability to spot and address problems that affect the timeliness of requesting and delivering Financial Products Specialists' services. Until performance measures are implemented, another step that can be taken to focus

attention on timeliness is providing managers with guidance on establishing specific time frames for completing examinations that are aligned with the LMSB Division goals.

In addition to improving the timeliness of requesting and delivering Financial Products Specialists' services, a control process is needed to ensure these specialists have an opportunity to assist in determining which IC corporate examinations could benefit the most from their involvement.

Management's Response: Internal Revenue Service (IRS) management agreed with the findings and recommendations presented in the report. IRS management indicated that they are developing an Electronic Referral System that will accelerate the referral time and serve as a control process for monitoring case referrals. IRS management will also notify all employees of the timeliness goal, share the Field Specialist Business Plan with all managers, and emphasize cycle time. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to IRS officials who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

**The Financial Products Specialist Program Controls Could Be Improved to
Ensure More Timely and Accurate Examinations of Large Corporations**

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The Financial Products Specialist Program Controls Could Be Improved to Ensure More Timely and Accurate Examinations of Large Corporations

Background

The term “financial products” generically describes a variety of instruments sold by investment companies and others in the financial services industry. Conventional financial products include equity securities such as stock and debt instruments such as bonds. Other less conventional financial products include stock options and stock index futures that can help corporations and other investors to offset risks or hedge against possible losses from other investments.

The Internal Revenue Service’s (IRS) Financial Products Specialist Program (FPSP) began in response to the use of aggressive new products in financial markets that generated significant tax benefits. Today, the IRS has selected approximately 147 experienced examiners to become Financial Products Specialists by training them to understand the various products, tax law, terminology, and systems of accounting used in the financial services industry. The Commissioner, Large and Mid-Size Business (LMSB) Division, has overall responsibility for the FPSP, but it is directed within the LMSB Division under the Field Specialist Program.

Among its responsibilities, the LMSB Division is tasked with examining the nation’s largest corporations. For examination purposes, the LMSB Division splits these corporations into two groups. Of the approximately 58,000 large corporations, about 1,300 of the largest and most complex are classified as Coordinated Industry Cases (CIC), while the remaining are referred to as Industry Cases (IC).

CIC and IC corporate examinations account for \$13.9 (70 percent) of the \$19.8 billion in recommended additional taxes from all IRS examinations. However, the

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length of time it takes to complete the examinations has been an ongoing concern of both the IRS and stakeholders.¹

Large corporate examinations may not start for several years after the corporate return is filed and take several more years to complete. As part of an ongoing effort to improve the post-filing examination process, the LMSB Division has a strategic initiative to reduce the cycle time on CIC and IC corporate examinations.

This review is part of our Fiscal Year (FY) 2002 emphasis on the LMSB Division's post-filing examination process. We performed our work in accordance with *Government Auditing Standards* at the LMSB Division's Headquarters and offices in the New York, Chicago, and Los Angeles metropolitan areas from October 2001 to March 2002. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

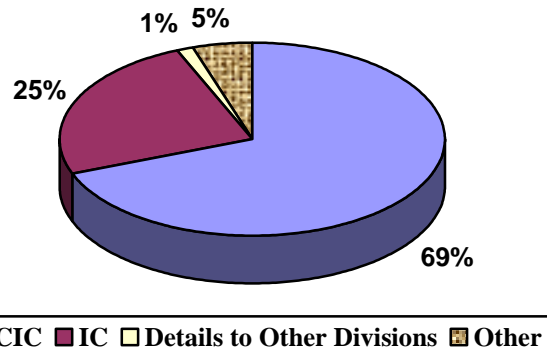
Coordinated Industry Case Corporate Examinations Benefited the Most From Financial Products Specialists

CIC corporate examinations are the largest and most complex examinations that the IRS conducts. Because of their size and complexity, these examinations consume a large portion of the Financial Products Specialists' time. As shown in Figure 1, documentary evidence obtained from the LMSB Division shows that the specialists spent about 69 percent of their direct examination time on CIC corporate examinations in FY 2001.

¹ For example, the Tax Executives Institute (TEI) has indicated that not being current in examinations creates record keeping burdens for corporations because, if examinations were closed in a timely manner, there would be less need to retain records.

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Figure 1: Financial Products Specialists' Direct Examination Time Allocation in FY 2001



Source: Treasury Inspector General for Tax Administration's (TIGTA) analysis of the IRS' FY 2001 Table 37 "Examination Program Monitoring."

Our analysis of Financial Products Transaction (FPT) System² data showed that the LMSB Division's investment in Financial Products Specialists is producing good results. Overall, the specialists spent approximately 7,419 staff days (59,355 staff hours) on 371 CIC corporate examinations that were closed in FY 2001 and recommended approximately \$3.8 billion in adjustments to taxable incomes and disallowed claims. From these data, we calculated that for each hour spent on a CIC examination, a Financial Products Specialist recommended about \$63,778 in adjustments to taxable incomes.

Financial Products Specialists' Services Need to Be More Timely Requested and Delivered

The time taken to request and deliver Financial Products Specialists' services may hamper the LMSB Division's ability to meet its FY 2002 and 2003 goals for timely completing IC corporate examinations. According to the FY 2002 LMSB Division goals, an IC corporate

² The FPT System is accessed through the Coordinated Examination Management Information System. IRS management uses the FPT System data to monitor the progress and results of financial products referrals.

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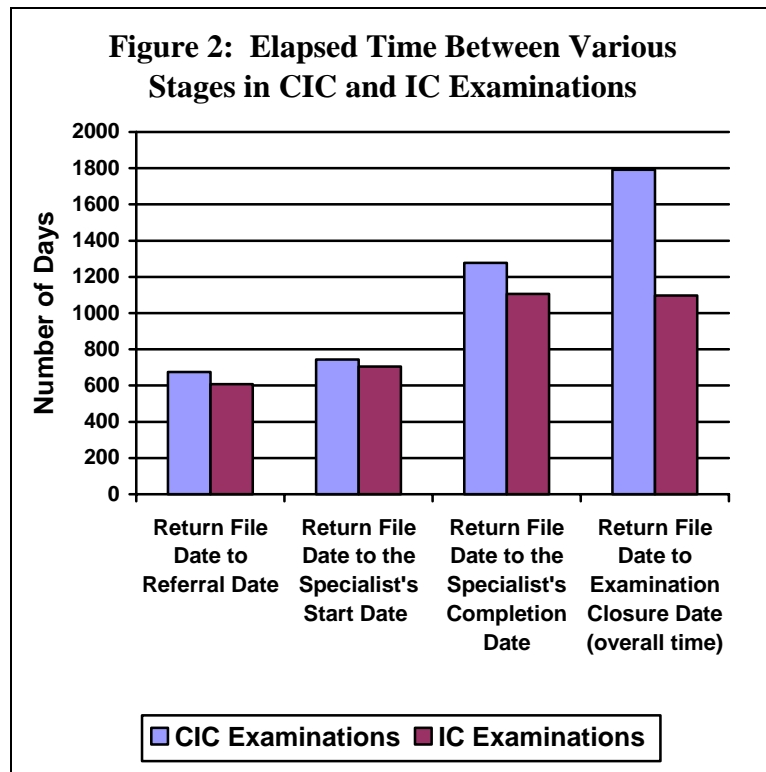
examination is considered timely if it is completed within 31 months after the return is filed, while a CIC corporate examination is timely if it is closed within 57 months of the return file date. In FY 2003, the goals for closing IC and CIC corporate examinations will be 29 and 54 months, respectively.

Our analysis of the FY 1995 through 2001 FPT System data, matched to the FY 2001 closed Audit Information Management System (AIMS) data, showed that the time taken to request and deliver Financial Products Specialists' services in IC corporate examinations was substantial. For example, it took, on average:

- About 5.6 months (169 days) for examiners to request the services of a Financial Products Specialist after they started an IC corporate examination.
- About 2 months (60 days) for a Financial Products Specialist to start working on an IC corporate examination once he or she was assigned.
- About 14.5 months (434 days) for the Financial Products Specialist to issue a report once he or she started working on an IC corporate examination.

Figure 2 shows the average elapsed time between when returns were filed and key stages in CIC and IC corporate examinations closed in FY 2001 that involved a Financial Products Specialist.

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Source: TIGTA combined analysis of the FY 1995 through FY 2001 FPT System data and FY 2001 closed AIMS data.

As the third from the left column of Figure 2 shows, the Financial Products Specialists' portion of time from the return file date to their completion was an average of 1,277 days (about 42.6 months) for a CIC examination, and 1,106 days (nearly 37 months) for an IC examination. The far right column shows that the overall time frame for CIC and IC corporate examinations closed in FY 2001 was 1,791 days (about 59.7 months) and 1,098 days (about 36.6 months), respectively.

The General Accounting Office's (GAO) *Executive Guide: Effectively Implementing the Government Performance and*

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Results Act and reports that we have issued³ discuss the need for controls that aid in setting priorities, adjusting resources, and providing the basis for improving performance. We recognize that the time span of examinations is not always under the direct control of Financial Products Specialists, examiners, and their managers. For example, taxpayers may procrastinate in responding to a Financial Products Specialist's report or requests for information and thereby extend the length of an examination. However, there are two other reasons why these delays are occurring that the LMSB Division could address to better focus attention on improving the timeliness of requesting and delivering Financial Products Specialists' services.

First, the centralized management information system is incomplete because the FPT System does not capture information on when an examination is started or why delays are occurring. In addition, key milestone dates such as planned start and completion dates are missing. As a result, the LMSB Division is limited in its ability to identify and address problems that affect the timeliness of requesting and delivering Financial Products Specialists' services.

Second, managers and Financial Products Specialists do not have guidance for establishing specific time frames for completing examinations that are aligned with the LMSB Division goals. While the Director, Field Specialists Program, has also recognized the need for and the importance of establishing time frames for completing examinations, as well as other performance measures, they have yet to be fully developed and implemented.

³ One example was our *Management Advisory Report: The Strategy for Curbing Abusive Corporate Tax Shelter Growth Shows Promise but Could Be Enhanced by Performance Measures* (Reference Number 2001-30-159, dated September 2001).

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Recommendations

The Director, Field Specialists Program, should take the following steps for improving the timeliness of providing financial products specialists' services:

1. Enhance the FPT System so that it can be better used to improve the timeliness of requesting and delivering Financial Products Specialists' services.

Management's Response: Management is designing a new Electronic Referral System (ERS). Management envisions the new system will accelerate the referral time because it will transmit the referral electronically. The new system will also capture critical information such as the referring team's examination starting dates and the specialist's starting and expected closing dates.

2. Until performance measures are implemented, provide guidance to managers for establishing specific time frames for completing examinations that relate to the LMSB Division's goals for timely examinations.

Management's Response: Management will notify all employees of the timeliness goal, share the Field Specialist Business Plan with all managers, and emphasize cycle time.

Significant Financial Products Tax Issues Are Often Overlooked in Industry Case Corporate Examinations

LMSB Division examiners are required to request the assistance of a Financial Products Specialist in determining the scope and depth of examinations involving corporations that report assets of \$50 million or more. While Financial Products Specialists were involved in CIC corporate examinations as required, examiners conducting IC corporate examinations do not consistently request the assistance of a Financial Products Specialist when examination procedures require such involvement.

We randomly selected a judgmental sample of 33 IC corporations reporting \$50 million or more in assets from across the nation whose examinations were completed in FY 2001 and FY 2002 and determined that mandatory Financial Products Specialist referrals were not made in

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24 (73 percent) of the 33 cases. Several LMSB Division Financial Products Specialists reviewed our exception cases and found that approximately \$118 million of potential financial products tax issues were not referred to a specialist.

The GAO's *Standards for Internal Control in the Federal Government* specify that control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives. In short, controls ensure actions are taken to minimize risks. We applied these standards in evaluating the problem with the limited number of referrals made to Financial Products Specialists in IC corporate examinations. Our results indicate that the LMSB Division controls to meet its guidelines on involving Financial Products Specialists in examinations were not always effective or adequate.

We believe the controls were not effective because the LMSB managers and IC examiners we spoke with were aware of the guideline to request the assistance of Financial Products Specialists. However, they did not always follow the guideline. This happened because they saw no potential financial products issues worth examining or did not want to involve an "outside" specialist due to concerns that the process could be time consuming and, thereby, delay closing the examination. Considering that Financial Products Specialists spent, on average, about 37 months to complete their portion of an IC corporate examination in FY 2001, there may be justification for these concerns.

The controls were also not adequate because they did not ensure a Financial Products Specialist has an opportunity to review all large corporations in the examination stream. In the past, establishing such a control was difficult because all large corporate returns were placed in the examination stream so that they could be manually screened for tax issues by examiners or their managers in local IRS offices. The screening process and criteria used could vary by office, and most of the returns that were entered into the examination stream were eventually eliminated from consideration.

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Today, the LMSB Division uses a centralized and much more structured approach to select large corporate returns for examination. All large corporate returns are filed only at the IRS' Ogden Submission Processing Center rather than at all 10 Submission Processing Centers located across the country. To determine which returns to select for examination, the LMSB Division scores the returns on specific criteria that results in fewer returns remaining in the examination stream.

Given the Financial Products Specialists' role in identifying significant tax issues, they should not have to depend on examiners less qualified and experienced in financial products tax issues to determine if and when their involvement is needed. Rather, a control is needed to ensure they have an opportunity to evaluate all returns selected for examination, particularly now that significantly fewer returns remain in the examination stream and come from a centralized location.

Recommendation

3. The Director, Field Specialists Program, should coordinate with the LMSB Division's Industry Directors to establish a control process that cannot be easily ignored, so Financial Products Specialists have an opportunity to assist in determining which IC corporate examinations could benefit the most from their involvement.

Management's Response: Management will use the new ERS to establish a control process for monitoring case referrals.

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Appendix I

Detailed Objective, Scope, and Methodology

Our objective was to assess how timely the expertise of Financial Products Specialists is requested by and delivered to the Large and Mid-Size Business (LMSB) Division examiners. To meet our objective we relied on the Internal Revenue Service's (IRS) internal management reports, databases, and review of a sample of Industry Case (IC) and Coordinated Industry Case (CIC) corporate examinations. We did not establish the reliability of these data because extensive data validation tests were outside the scope of this audit. Except as noted above, our work was conducted in accordance with *Government Auditing Standards*. Our specific audit tests included the following:

- I. Defined the purpose, scope, inputs, outputs, and customer needs of the Financial Products Specialist Program by reviewing the LMSB Division's guidelines and interviewing LMSB Division executive level, mid-level, and front-line managers.
- II. Analyzed Fiscal Year (FY) 2001 data from the Examination Program Monitoring Table 37 and FY 1995 through FY 2001 data from the Audit Information Management System and the Financial Products Transactions (FPT) System to determine the Financial Products Specialist staffing levels, results from their examinations, and where they applied their examination time.
- III. Analyzed the FPT System data and reviewed a judgmental sample of 18 open CIC corporate examinations from the Los Angeles and Chicago metropolitan areas to determine whether examiners were requesting the assistance of Financial Products Specialist as required, how much time was involved in requesting and delivering the assistance, and if the Financial Products Specialists were unnecessarily extending the length of examinations. A judgmental sample was used because a statistical sample to project results would have required extensive resources and time.
- IV. Analyzed the FPT System data and reviewed a judgmental sample of 33 closed IC corporate examinations from across the nation to determine whether examiners were requesting the assistance of Financial Products Specialists as required, how much time was involved in requesting and delivering the assistance, and if the Financial Products Specialists were unnecessarily extending the length of examinations. A judgmental sample was used because a statistical sample to project results would have required extensive resources and time.
- V. Verified whether specific time frames and other performance measures have been established for requesting and delivering the technical advice from Financial Products Specialists and if the measures were aligned with those in the LMSB Division.

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- VI. Reviewed the General Accounting Office's (GAO's) *Executive Guide: Effectively Implementing the Government Performance and Results Act* and prior reports issued by the Treasury Inspector General for Tax Administration to assess the applicability of performance measures for Financial Products Specialists.
- VII. Applied the GAO's *Standards for Internal Control in the Federal Government* to existing controls over requests for, and delivery of, Financial Products Specialist services and evaluated whether risks were sufficiently minimized.

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Appendix II

Major Contributors to This Report

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Phil Shropshire, Director

Frank Dunleavy, Audit Manager

Earl Charles Burney, Senior Auditor

Stanley Pinkston, Senior Auditor

Jean Kao, Auditor

William Tran, Auditor

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Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner N:DC
Deputy Commissioner, Large and Mid-Size Business Division LM
Director, Field Specialists, Large and Mid-Size Business Division LM:FS
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaison:
 Commissioner, Large and Mid-Size Business Division LM

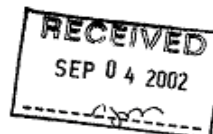
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Appendix IV

Management's Response to the Draft Report




DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224



August 30, 2002

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:  Larry R. Langdon
Commissioner, Large and Mid-Size Business Division

SUBJECT: Draft Audit Report – The Financial Products Specialist Program Controls Could Be Improved to Ensure More Timely and Accurate Examinations of Large Corporations (Audit # 2002-30-006)

The Financial Products Specialist (FPS) Program is one of the LMSB Division's top priorities. The FPSs assist the LMSB Division with the examinations of the nation's largest corporate returns. Since its implementation in FY 2000, the FPS Program is producing excellent results. The specialists are generally involved in the examination of highly significant and very difficult issues. Often, they work on emerging or novel tax issues that have no previous regulatory or judicial guidelines for reference. Currently, the FPS Program is providing essential support to another LMSB Division initiative--combating abusive corporate tax shelters. Sixty two percent of all FPSs are working on examinations of tax shelters. Today's tax shelters include a variety of financial transactions embedded in a number of entities ranging from offshore partnerships, trusts, and holding companies. The FPSs play a crucial role in the development of the issues, including the review of voluminous documents, interviews of tax shelter promoters, and analysis of the Internal Revenue Code sections relevant to the various shelters.

The Field Specialist Office is working to further improve the timeliness and effectiveness of the FPS Program. The FPSs support our strategic goal to reduce the time on Industry Case (IC) and Coordinated Industry Case (CIC) examinations by promptly responding to the industries' request for specialist services. In addition, members of the Field Specialist Task Group designed a new on-line specialist referral form for use by all operating divisions. The new referral form will capture the data we need to monitor the timeliness of the referral process.

The following are our specific comments on the draft report findings and recommendations.

IDENTITY OF FINDINGS AND RECOMMENDATIONS:

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FINDING:

FPSs' services need to be more timely requested and delivered.

ASSESSMENT OF CAUSE(S):

I share your concern on timeliness. Examiners often try to work financial product issues first, without assistance from the specialists, and realizing late in the process the great difficulty of the issues. Although the Internal Revenue Manual specifies the requirements for submitting timely referrals, some examiners are not aware that certain industry cases are mandatory referrals. In addition, FPSs require a significant amount of training and experience to examine documents on the various financial instruments and determine the correct tax treatment of the products.

Your report states that it takes 60 days or 2 months for the FPS to start an IC corporate examination. I would like to clarify this issue. The specialists do not control the starting date. We often have good reasons for delays in the starting date, which could include lack of space at the audit site, unavailability of the requested documents, or delays by the taxpayers. I believe a better measure of timeliness would be measuring the days lapsed between the referral date and the assignment date because the Financial Products Manager can control this period.

Your report also states that it takes 434 days or 14.5 months for the FPS to issue a report once the specialist started working on an IC corporate examination. Some referred cases take a long time to complete because they often contain complex and significant issues. For these cases, specialists have to review voluminous records, interview taxpayers and other stakeholders, and develop novel audit techniques. Many times, they have to request Field Service Advice or Technical Advice Memoranda from the Chief Counsel's Office.

RECOMMENDATION 1:

The Director, Field Specialist Program should enhance the FPT System so that it can be better used to improve the timeliness of requesting and delivering Financial Products Specialists' services.

CORRECTIVE ACTIONS:

The design of the new Electronic Referral System (ERS) is almost complete. This system will allow all operating divisions to make referrals to field specialists. In addition, the system will capture the mandatory referral criteria for all the specialty programs. For example, if an examiner enters an activity code while making a referral to the Computer Audit Specialist Program, a system indicator will alert the examiner about the need to refer the case to all other specialties. This will significantly increase the number of referrals made at the beginning of an examination. The ERS will accelerate the referral time because it will transmit the referral electronically. The new system will also capture

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critical information such as the referring team's examination starting date and the specialist's starting and expected closing dates.

IMPLEMENTATION DATE:

PROPOSED DATE: October 31, 2002 – ERS roll out

RESPONSIBLE OFFICIAL:

Keith Jones, Director, Field Specialists

CORRECTIVE ACTION(S) MONITORING PLAN:

We are testing the new ERS System with one group from each of the specialty programs. For tracking and monitoring, managers will use special surveys, sampling and data analysis, management control reviews, audits, and staff interviews.

RECOMMENDATION 2:

Until performance measures are implemented, the Director, Field Specialist Program should provide guidance to managers for establishing specific time frames for completing examinations that relate to the LMSB Division's goals for timely completion.

CORRECTIVE ACTIONS:

The Director, Field Specialists Program is already providing guidance to managers on time frames for completing examinations. The FY 2003 LMSB Compliance Plan includes reducing cycle time as a goal. We developed the Field Specialist Business Plan based on the goals outlined in the LMSB Operating Plan. As part of the planning process, we complete an Audit Plan for CIC cases. Generally, all parties to the Plan agree on closing dates, and managers are aware of the specific time frames that are necessary to complete the examinations. This process is common practice among the field specialists.

Once we finalize the Field Specialist Plan, we inform all managers. Managers submit reports every two months on their actions to support the plan. In addition, each manager signs off on the Audit Plan for CIC cases. The Audit Plan specifies estimated closing dates that the specialists must follow. Team managers must approve changes to closing dates and document the request for extensions, including a risk analysis for each case. For IC cases, the audit plan process is less formal and initiated on receipt of a referral.

We will notify all employees of the timeliness goal. Also, we will share the FY 2003 Field Specialist Business Plan with all managers by October 31, 2002, and emphasize cycle time.

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IMPLEMENTATION DATE:

PROPOSED DATE: October 31, 2002 – Distribution of the Field Specialist Business Plan

RESPONSIBLE OFFICIAL:

Keith Jones, Director, Field Specialists

CORRECTIVE ACTION(S) MONITORING PLAN:

We will continue to require managers to follow the Field Specialist Business Plan procedures.

FINDING:

Significant financial products tax issues are often overlooked in Industry Case corporate examinations.

ASSESSMENT OF CAUSE(S):

Many examiners in the field underestimate the difficulties of the financial product issues. As mentioned earlier, many examiners feel they have the knowledge to determine that no issues exist worth examining. These examiners may also bypass referrals to the specialists due to concerns that the process is time consuming and may delay examinations. Your report states, "Considering that FPSs spent, on average, 37 months to complete their portion of an IC examination in FY 2001, there may be justification for concern." Your statement should consider that we have significant time lapses between the date the taxpayer files the return and the date the examiner makes the referral. As mentioned earlier, examiners will often try to work the issues themselves before they make a referral.

RECOMMENDATION 3:

The Director, Field Specialist Programs should coordinate with LMSB Division's Industry Directors to establish a control process that cannot be easily ignored, so FPS have an opportunity to assist in determining which IC corporate examinations could benefit the most from their involvement.

CORRECTIVE ACTIONS:

We will use the new ERS to establish a control process.

IMPLEMENTATION DATE:

PROPOSED DATE: October 31, 2002 – ERS roll out

The Financial Products Specialist Program Controls Could Be Improved to Ensure More Timely and Accurate Examinations of Large Corporations

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RESPONSIBLE OFFICIAL: Keith Jones, Director, Field Specialists

CORRECTIVE ACTION(S) MONITORING PLAN:

Managers will use the ERS to monitor case referrals and develop program reports.

If you have any questions, please contact Keith Jones, Director, and Field Specialists at (202) 283-8290.